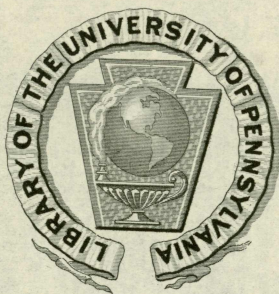


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ECONOMIC RECONSTRUCTION: FOREIGN AND DOMESTIC INVESTMENTS

ANNUAL ADDRESS OF THE PRESIDENT

JOHN R. COMMONS

The University of Wisconsin

The doctrine of *laissez faire* had a practical and a theoretical origin. On the practical side was the inefficiency and the autocracy of government. On the theoretical side, the doctrine of the Law of Nature and the natural rights of the individual.

It needed no proof in the eighteenth century that government was incompetent and despotic. The fact stood out in every attempt of the middle classes to take advantage of the discovery of America, of the new expansion of markets, and the new inventions of machinery.

Great Britain, by the accident of her island more than the theory of her philosophers, proved that, in order to conquer and settle the New World, to expand her markets, to invent and use machinery, government does most when it does least. The westward ho! of Britain's free-booters and discoverers, the eastern and westward conquests of the Plymouth, the London, the East India, and other companies of "adventurers"—in short, the private initiative and private capital of her ungoverned subjects—gave to England a navy and an empire. Then, when her inventors and manufacturers escaped from the governmental regulation of the town guilds to the unregulated open country of Manchester and Birmingham, it was private initiative and private capital that gave to England her wealth and a world market.

Finally Adam Smith, borrowing from France the philosophy of a benevolent law of nature, the rule of Universal Reason, justified in theory what England had already demonstrated in practice.

And so England, by her happy experiment, got the start of the rest of Europe by one or two hundred years, but tied herself to a theory of *laissez faire* which assumed that the conditions would always hold the same. The experiment and its theory have brought her, indeed, the wealth of nations, but the theory put her asleep while another experiment and another theory were shaping themselves to snatch her wealth and perpetuate her sleep.

The theory of the beneficent Law of Nature started from the hypothesis of both the incompetency and the autocracy of gov-

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ernment. But now we see, not that the hypothesis was false, but that it was provisional. The most autocratic government remaining over from the eighteenth and nineteenth centuries of Europe is the most efficient.

The old theory started, too, with the assumption that power and liberty are two mutually exclusive and hostile principles in the life of a nation. Power is the power of despotic government, the force that gives sanction to the personal decrees of a sovereign—in short, power is arbitrary coercion. But liberty is freedom from coercion. It is escape from the power of the state and refuge in the benevolence of nature. So, liberty is conformity to the laws of nature; power is violation of nature's law.

But the new theory of Germany starts with the hypothesis that the power of the state is not a violation, but the ripe fruit and the evolutionary outcome of the laws of nature. Power is the rule, not of reason, but of will; and nature is not reason, as it was to the philosophers of the eighteenth century, but, to the philosophers of the twentieth century, nature is *will*, and the highest will on earth is the will of the state. There are, therefore, no natural rights of individuals superior to the will of the state, and consequently no corresponding duties of individuals, no morals, no ethics, no sanctity of private contracts nor of international treaties—nothing, indeed, that looks for its validity towards any so-called law of nature, if that conflicts with the highest law of nature, which resides in the will of the state.

But this culmination of the will of nature in the will of the state, with its absorption of private will into political will, requires something to take the place of liberty. Although liberty finds no support in a fictitious natural law or natural rights, yet still the greatest thing that contributes to the power of the state is this very private initiative, private inventiveness, the energy of the individual. Sweep away his natural rights by substituting the will of the state for the reason of nature, and there must be substituted, not indeed that arbitrary coercion which provoked *laissez faire*, but such a scientific use of the power of the state, based on accurate knowledge of human nature, as will lead the individual to exert himself to the utmost. Abolish liberty, but substitute inducement. Offer rewards, promotions, distinctions, honors, bonuses, subsidies, establish technical schools and an educational system that will oversupply the market for brains. Obtain the maximum output of human energy for the sake of the

state, with the minimum expenditure from the resources of the state. Govern the people, not by liberty, but by psychology; not by reason, but by scientific management; not by laws of nature, but by inducements to human nature.

So we today are seeing the clash for control of the world between these two great experiments and their two appropriate theories. On the one side is *laissez faire*, keep hands off, the doctrine that weakens the power of the state to enhance the liberty of the individual. On the other the doctrine of power that strengthens the state through scientific and economical management of individuals.

Whatever the outcome, today is a day of reconstruction—reconstruction of theory and reorganization of practice.

The underlying theory of all the political and social sciences is the theory of value. I need not say that economic theory rests upon the *laissez-faire* philosophy of Adam Smith and the eighteenth century. It rests upon the isolated and ungoverned individual seeking the highest net income for himself. Sociologists, in recent years, have done much towards devising a social theory of value, and economists have profited thereby. But there is needed also a political or juristic theory of value.

The latter has already been rising up out of our American democracy and the decisions of the Supreme Court of the United States. In the decisions establishing the power of the state to make special assessments on account of the value of special benefits; then in the so-called unit rule of taxation on the total value of public utility property; then in the quite opposite valuation of public utilities for purposes of rate regulation; in these and other decisions peculiar to our American system the Supreme Court of the United States goes back to a theory of value as a contest of power between individuals and classes in the community. A court of law, unlike the economist, begins its theory of value from the standpoint of two opposing litigants, representing two opposing classes, with opposing rights and duties, instead of an isolated individual exploiting nature which is the state without rights or duties. Out of these contests of legislatures with courts, and of litigants with litigants, over value as power has come, not a *laissez-faire* theory of value resting on the psychology of business in a state of nature, but a juristic or political theory of value, resting on the struggles of American democracy for economic power and liberty through politics. It is a theory whose starting

points are the constitution, the bills of rights, the definitions of private property, the sovereignty of the state, and which seeks its standards of value through notions of equal opportunity, equality of bargaining power, solidarity of interests, and public utility.

Again, the American theory of *laissez faire* springs, not from the autocracy of government, but from its inefficiency. There was, in our early history, no effective a priori objection to the state undertaking anything that the people wanted. But when the experiments broke down through bankruptcy the same people wrote *laissez faire* into the constitutions.

On the other hand, our theory of natural rights has *not* been a theory of *laissez faire*. It appeared in our Declaration of Independence, not in order to foreclose anything from governments controlled by ourselves, but in order to justify our escape from the autocratic government of England. Rather has our theory of natural rights been a theory of the equal right of anybody to get all he can out of the government. It did not stand in the way of a high protective tariff, but rather helped along a log-rolling tariff.

So with our natural resources and public domain. The homestead law and its many collateral timber, desert, and mining acts were a conclusion from the natural right of anybody to get anything that belonged to the government. I need only mention the river and harbor and the public building appropriations. They, like the tariff, logrolled the taxing power of the state. And even the public offices in federal and state governments came to be the natural and equal right of any individual.

No, our theory of natural rights has not been a *laissez-faire* theory of government, but a pork-barrel theory. Not a let-alone theory but a let's-grab theory. And it is embedded deep in our every relation to the government, while the river and harbor bills are its picturesque outcropping.

And this theory was roughly suited to the nineteenth century of America. It was the century of conquest of Indians and Mexico, of expansion and occupation westward, of civil war that centralized power. But, unlike the theory that the state is power for the sake of more power, it is a theory that the state is power for the sake of individuals. Unlike the theory of *laissez faire* that the state is a necessary evil, it is a theory that the state is the political method by which individuals unite to use the sovereign power for their own purposes.

The weakness of the theory is its immaturity and its inefficiency. The pork-barrel theory is not wholly false. It established for the nineteenth century the truth, as we see it in America, that the state exists for the sake of its individuals.

But the theory is a half truth. Nature may endow the individual with rights, but she does not seem to burden the same individual with duties. The duties are imposed on other persons. But if rights proceed, not from nature, but from the state, then the very act that grants a right imposes ~~an equivalent~~ ^{a reciprocal} duty in contemplation of it. This we now have begun to recognize. The equivalent duty is not only on other persons to respect the right, it is on the person who has the right to vindicate himself.

This is the missing half of the pork-barrel theory. It was not missed particularly in the nineteenth century, when those who did not have rights of property could move west and get them. It is missed in the twentieth century when those who are short on rights are compelled to make terms with those who have them. And it is this other half of the doctrine that has already begun, in the nineteenth century, to force its way up and to offset both the natural rights of the individual and the pork-barrel theory of the state.

At the very height of the victorious westward sweep of the doctrine of natural rights, the Supreme Court of the United States, in the "Granger" railroad cases, went to an extreme limit in denying it, for, according to that decision, the property of individuals affected by a public use rests, not on their natural rights, but on their power to persuade the voters at the elections. Since that time almost every class of property, in one direction or another, has become affected by a public use and the election returns.

Along with these decisions have come those which established the so-called unit rule of taxation. A public utility corporation is no longer assessed merely on its physical property, such as buildings, lands, and houses, but on the capitalized value of its total earning power as a unit—on the market value of its stock and bonds.

Likewise with the theory of assessment for special benefits. This peculiarly American doctrine springs from the instinctive practice of American democracy. When a local government—a city, town, or village—constructs a public improvement, say a street or a highway, the cost of construction may be assessed, not against all of the taxpayers, but against those whose property

is especially augmented in value by the improvement. The special assessment, as pointed out by T. S. Adams, is a kind of excess-profits tax. It is a tax on the unearned increment, and large sums of money for public improvements are raised in this way.

In every case of a public improvement we see a contest, or at least a contrast, between the special-benefit theory and the pork-barrel theory. The state and federal governments are still in the pork-barrel stage. Rivers, harbors, and public buildings are paid for out of taxes upon the nation as a whole, instead of by assessments on the local real estate owners who are benefited.

These three classes of decisions regarding the value of property have changed the definition of property itself. Property is no longer the eighteenth century notion of holding a physical thing exclusively for one's own use, but property is value; value is power over others; and the court protects not necessarily the unregulated market value, but the reasonable value of property, against confiscation by the voters.

The political and judicial contests of the future, as in the recent past, turn on the power of the state and the power of private property; and their issue is the kind and extent of state control over the values of private property. It is this issue that is forced upon us more acutely by the world war.

In the westward movement of our population during the eighteenth and nineteenth centuries, the pioneers and settlers were led on, not mainly by the expectation of daily earnings, but by the expectation of future increments of land value. The pioneers were speculators. The same principle underlies all business. The so-called watered stock which promoters and financiers give to themselves and sell to others in starting a business is their claim to the speculative value, which they expect the business eventually to make good. Without this speculative element, in one form or another, private enterprise will not take hold of an investment.

But speculation acquired a new importance in the latter part of the nineteenth century. During three-quarters of the century, as has often been pointed out, there remained free resources to the west, and private enterprise was busy in occupying these resources. During the latter part of the century these resources were occupied and investors turned back and bid against each other for the resources already occupied.

So, in the early period, the increase in value of the occupied resources was limited by the opportunity to go elsewhere, and

consequently the expected reward to speculation could not be excessive. In the later period the increase in value of resources comes to be limited only by the low rates of interest that investors are willing to accept. The lower the rate of interest the higher the price the investor is willing to pay for the property that yields the interest. In the early period speculation served to develop new resources. The nation could afford the high exceptional rewards, for they added to the national wealth. In the later period it served to force up the values of resources already owned, and in so far does not add to the national wealth, but to the power of owners to extract a share from the national income.

Yet there remained still another source of speculative profits. It was the consolidations, under combinations and trusts, of resources already developed. The trust financing of later years could afford to pay high prices for established plants and still leave a speculative profit, by reason of their new economies and their new power over prices.

But now this source of speculation is also closing. The former low speculative values, with their expectation of high profits, are swallowed up by high investment values satisfied with relatively low rates of interest. Consequently, within the past decade or two, it is towards Mexico, Canada, China, Central and South America, Africa or Russia, where the speculative investment is low, that American capital has begun to look for high profits and future increases in the value of property. The frontier has moved out of our own country and the speculative values of the future are in the backward countries of the earth.

Here the government again is brought in. If these speculative values are to be realized, it will be because they are protected by the diplomacy and ultimately by the military power of the state. If thus protected, then the stocks and bonds that represent the low speculative values of these foreign holdings will be sold to our own people at high investment values based on the lower rates of interest which investors get at home. Thus the vested right to military protection abroad will grow with what it feeds upon.

Surely, our government rightly hesitates before it ventures out on this new frontier. It may be that our demand for the "open door" will force us hereafter to join with Europe in the protection of investments in backward countries. An enduring world peace can scarcely be looked for without both the open door and military protection for such investments. And this, of course, means op-

portunity for American speculation to collect the savings, the surplus capital of Americans, for investment abroad.

Yet our land differs from Europe. Europe is both overpopulated and overinvested, compared with ourselves. Germany could be crowded into one or two of our greater states. From the national standpoint we need to keep American capital at home. From the speculative standpoint it will not stay at home. We may refuse to protect it abroad, with the idea of *forcing* it to stay at home; but that will not suffice. It will then merely seek the cover of that flag, or that alliance of flags, which comes out victorious in the present war.

This, then, is the momentous issue into which our surplus capital and our high investment values with their corresponding low rates of profit have brought us. Wars in the past have been fought over exports of products and annexations of territory. These issues are, of course, present in this war, but, more important for the future is the issue of investment in backward countries, of lending our savings to foreigners—the export of capital as well as the export of products.

Yet our country needs our surplus capital. We cannot prohibit it from going abroad. We can only compete with the international speculative financier who invites it to go abroad.

And this competition can be met only by the state in its several divisions of local, state, and federal governments. Already the federal government has begun to compete. The irrigation and reclamation projects, the subsidies to industrial education—in these cases the state is using its taxing power in such a way as to divert the possible savings of the people away from the international financier and into the development of our own resources.

The government has this advantage over the financier—it can *force* savings to be diverted by means of the taxing power, and it can *induce* them to come at lower rates of interest on its own bonds or on the bonds that it guarantees. And with the high values and consequently high initial investments now required it is only this power to get capital by taxation or at low rates of interest that can make possible, on a sufficiently large scale, these internal improvements.

Not only a far-reaching system of rural credits, of land reclamation, and of local highways, but also a huge extension of railways, is a pressing need. It is estimated that the railways will require, within the next ten years, over a billion dollars a year of

new capital. Private capital will not invest at the low rates of profit allowed under government regulation. Rather should we say, private financiers will not undertake to collect the needed capital from investors unless they are allowed the speculative values of future unregulated profits.

I need not enlarge upon the reasons for which government has eliminated speculation in the railroad business. It was closely connected with the effort to do away with discriminations. Private speculation does not go where service is needed the most, but where the returns are highest. Consequently the private financier seeks the business of the great corporation or the great city; and this, instead of mainly developing the country, mainly adds to the values already developed.

The next step was inevitable: that of limiting the profits as a whole by regulating the entire schedule of rates. And it is this that stands in the way of obtaining the one or more billions of capital needed every year in order to catch up with the growth of the country.

Our experience in this respect is not different from that of other countries. It has been mainly the fact that private financing could not get the capital needed for the national necessities, whether military or industrial, that has forced other countries either to subsidize railways, or to guarantee their stocks and bonds, or to purchase them outright.

One or another of these methods we must look to as inevitable. A general increase in freight rates offers no assurance either that the new capital will be obtained, or, if obtained, that it will be used where it is needed for the development of the country.

The same is true also if the railroads are subsidized or if interest on the new capital is guaranteed. The main object is to take out of the hands of the speculative financier the power to decide where the new extensions shall be built, the new terminals be provided, the new rolling stock be furnished. This is already done in some states in a negative way by giving to the state commissions power to *veto* issues of stocks and bonds, or to *prohibit* duplication of lines. But it is not done in the positive and necessary way of ordering new lines to be built where the country most needs them. Whether the state subsidizes or guarantees or owns the railroads, it must be the government that decides positively where the money shall be spent.

But in all of these cases of proposed internal development, the

pork-barrel theory of government threatens governmental bankruptcy by diverting the benefits of national taxation and low rates of interest into further increased values of local real estate.

Already certain reclamation projects have pushed up the investment values of land and burdened the actual settler with fixed charges which drive him in turn to demand relief, not of the speculator who has benefited, but of the government that has advanced the capital. In these reclamation cases there was no theory of value to guide the engineers who laid out the projects. Almost the entire increase in value which the government added to the property went to the speculative owners instead of to the actual farmers. And now the government is asked to forego even its low rate of interest, and perhaps the principal itself, so that the farmer can make a living after having paid the speculator. The alternative is bankruptcy for the farmer or more taxes for the people.

Likewise with the subsidies to rural highways. In every state we see the unseemly struggle between localities to get hold of this state and federal taxing power which gives a special and permanent benefit to local real estate. Had the special-benefit theory been adopted, then the states and federal government would first decide what highways are needed in the public interest and then require the benefited property to refund the expense, to the extent of the benefit.

More serious is the case of railways. The weightiest objection to the government ownership of railways is the dreaded scramble in Congress to get local extensions, terminals, and new lines whether needed or not by the nation as a whole. The imagination is stunned by the possibilities of logrolling and national bankruptcy from this source, if the government owns the railways. But with the doctrine of special benefits, namely, that the benefited property of each locality and not the taxes of the nation should be required to pay the expenses of permanent improvements, the government might advance on a policy of public ownership without fear that local private interests would logroll the general public interest. Indeed, here again, as in the case of government subsidies for rural credit, for reclamation and for highways, the special-benefit theory is a specific against the fatty degeneracy of the pork-barrel theory. The inducement to logroll for special benefits is reduced if those who get the benefit are required to pay for it.

The problem of getting new capital for economic reconstruction after the war is the serious problem thrown upon us by the war. Already the warring nations have begun to stagger under the load of debt for military purposes. The burden of debt means heavy taxes. New sources of revenue must be found. These taxes may be levied in such a way as to burden industry and handicap private enterprise, or in such a way as to place the burden on various kinds of excess profits, unearned increments, and special benefits. The latter tends to reduce the taxes on new capital, going as far in some cases as to exempt it altogether from taxation, and so to unburden industry and invigorate private enterprise. This is the lesson taught by the American system of special assessments on account of special benefits. Capital is raised for public improvements, not by burdening the investor, but by taxing an unearned increment.

But it is not only new sources for obtaining capital that the war has forced us to seek; it is also a new way of telling where it shall be invested when found. Here the war has also forced the method upon our attention. It notifies us that the doctrine of *laissez faire* is dead. The nation that killed it now threatens to build world empire on the others that did not know it was dead. In whatever direction we look, even in our own country, we see interested parties arranging its funeral. And it is dead just because it cannot secure new capital to be invested where either the nation or those directly interested want the investment to be made. If it is the foreign export of products that we want, then the nation must provide a merchant marine by means of taxes or subsidies. If it is the open door for foreign investment and export of capital to backward countries that we want, then the nation must tax or bond itself for armies and navies to protect those investments. And if it is the development of our own resources that we want, by means of highways, railways, rural credit, reclamation, or industrial education, then the nation again must tax itself or bond itself or guarantee private bonds in order to subsidize the needed improvement.

Laissez faire is dead, and the only question is, where shall the state employ its taxing power and its borrowing power in order both to get and to invest the new capital?

If the foregoing analysis of American theories of value, of property, and of sovereignty, has significance, it lies in this: that American democracy and its Supreme Court have already given

an answer, and the answer is a kind of specific against the very evils of the pork-barrel that drove America into the lap of *laissez faire*. The answer is that the new capital be raised by various kinds of special benefit assessments on all kinds of property or income that are specially benefited by the activities of local, state, and federal governments; that taxes be reduced or discontinued on those forms of industry that are not specially benefited and that therefore must compete with the international financier for new capital that can flow anywhere on the world market; and, finally, that the state employ its borrowing power, backed by its taxing power, to buy and operate those essential and basic industries, whether highways, railways, mines, forests, or water-powers, upon which all industries depend for materials, for mechanical power, and for markets.

These may rightly be said to be the lessons both of the war and of American democracy.

I do not overlook the fact which originated and now supports our *laissez-faire* theory, namely, the incompetency of government to administer a public business. Just because our pork-barrel theory encourages individuals and classes to logroll and get all they can out of government without giving much in return, it follows that they wish to see an inefficient government that cannot protect itself against them. But when we realize that our liberty and property depend upon a competent civil service and an expert administration of government, then we make sacrifices and pay attention in order to strengthen that administration. Thousands of our successful business men, professional men, and labor leaders, through their service on councils of defense and other public bodies, are now learning both the vital importance of public business and the reasons for its incompetency; and government officials are learning that they cannot administer public business without the assistance of these same representative private citizens.

Our inefficiency is a state of mind, a pork-barrel theory, a *laissez-faire* philosophy. By reason of it we have built up great private interests whose speculative profits render them hostile to a strong and efficient government, except where it helps them. By a different state of mind we are already building up great public interests that require and are beginning to get the coöperation of private interests.

But it is also objected that these are the teachings and devices, not of American democracy, but of German autocracy, whose

example we must avoid. Rather are they the processes by which Germany is mastering the world. Germany is forcing us to become a great military and naval power. What if she forces us to become an efficient industrial power?

It depends on the purpose. Modern industry is much alike in all countries and its conditions of efficiency are much the same. But the purposes for which it is used may differ. If our purpose is to make use of our people in order to gain more power for the state over other nations, then, as contributing to that purpose we shall raise capital by taxation and invest it in navies and armaments and shall back up speculative investments abroad. If our purpose is to open up our own resources for future billions of surplus capital and for future millions of population, then we shall raise capital, also largely by taxation, but shall invest it in those basic industries which no longer can be left to speculation.

Only government can choose which of these purposes shall be first. The will of the state decides. And already have American democracy and the Supreme Court begun to point out both the theory and the practice by which the American government may give a preference to domestic investment over foreign investment.

FEDERAL TAXES UPON INCOME AND EXCESS PROFITS

By T. S. ADAMS

Yale University

The subject allotted to me is a large one and I have attempted little more in the following paper than to state some of the larger problems and the solutions which at this time seem most promising. It is necessary to add, moreover, that I express only my own personal opinions.

I. *Nature of the Excess-Profits Tax*

The first American excess-profits tax (of March 3, 1917) was a moderate, flat tax on the income of corporations and partnerships in excess of 8 per cent upon actual capital invested; it was later changed by the Senate Finance Committee to a tax on war profits; and finally after protracted discussion was changed back to a highly graduated tax on the "supernormal" income of individuals, partnerships, and corporations. The excess-profits tax in its present form represents a conscious and deliberate victory of the excess-profits principle over the war-profits principle.

The conviction that carried the day for the excess-profits principle was the knowledge that, adventitiously, some industries (e.g., the automobile industry) were exceptionally prosperous just before the war, while some other industries (e.g., the textile and lumber industries) were in an abnormally depressed condition during the "pre-war period." Congress apparently saw no reason why the industry which was exceptionally prosperous just before the war should on that account be immune from taxation during the war. Pre-war prosperity can establish no just ground for exemption during the war.

This was the principal judgment registered by the adoption of the war excess-profits tax of October 3, 1917. Congress decided to lay a special tax on "supernormal" income, whether the taxpayer chanced to have made exceptionally high or exceptionally low profits during the three years 1911-13. At the same time Congress decided to measure normal income as a part or percentage of invested capital, and not as an average of past profits. The latter decision I regard as of secondary importance. In the future it is not improbable that we shall employ past earnings as

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